The third quarter saw the global equity markets continue to rise while fixed income markets held their own, despite acknowledgement that higher rates are coming… sometime. As when we reported mid-year results, most major U.S. equity indexes currently sit at or near all-time highs, international and emerging market stocks are rallying, and bonds provided a more than reasonable total return. Last quarter we touched on our observation that even the most zealous non-believers were beginning to admit the rally in the global investment markets is for real. The capitulation of stock market bears continued during the third quarter, likely contributing to the overall markets continued move higher.

To avoid sounding like a broken record by discussing the strong fundamentals, low interest rates, and justifiable valuations yet again, I would instead prefer to discuss the role of human behavior in the performance of investment markets. It was recently announced that Richard Thaler, a professor of economics at University of Chicago Booth School Business, was awarded the 2017 Nobel Prize in economics. Thaler is best known for his "Nudge Theory" which suggested implementing easy interventions to change people's decision making. For example, one suggestion from his research was for companies to automatically enroll new employees in the company 401k-retirement program. He found that by doing so significantly more employees participated simply by requiring that they go through the process to opt-out as opposed to requiring that they take the time to enroll. Traditional economic theory had been and still remains based on the idea that humans act rationally. Yet his work and that of his colleagues recognized that while rational assumptions work in theory they rarely hold true in the real world. As an economics major in school and student of behavioral finance in practice, it is good to see Professor Thaler acknowledged for his contributions to the field of economics.

Yet it should come as no surprise that many investors have long been aware of the influence of human behavior on the investment markets. During the summer of 2007 as the investment markets here hitting all-time highs I was working for the chief investment officer of Legg Mason's ClearBridge Advisors (formerly Citigroup Asset Management.) One day, in what I now recognize as youthful naiveté, I asked why he was positioning the portfolios he managed in an increasingly more defensive manner even though the markets were at record highs. He responded by sharing the words of Bernard Baruch (well-known financier, stock investor, and philanthropist) that "the main purpose of the stock market is to make fools of as many men as possible." It has been almost ten years since the Great Financial Crisis and many investors have remained overly cautious since the low in early 2009. These investors having missed out on one of the greatest bull markets in history. It now appears that the pain of watching the markets grind higher day-after-day is proving too much for some and they are finally getting back into the stock market. We have warned that when doubters become believers it often marks the point when the "easy money" has already been made.

We are mindful of the lessons of behavioral finance as we conduct our investment analysis and portfolio construction. We attempt to weigh the underlying factors contributing to investment returns against those factors we have identified as contributing to risk. Currently it can be argued that the underlying fundamentals point towards continued positive returns. Yet we recognize the chorus of "market cheerleaders" is growing and this in turn encourages us to take a slightly more conservative outlook. Our less bullish outlook should not be confused with the prediction of an ensuing crisis. Rather, we hope to take advantage of market strength in order to realign our clients' portfolios to better match their risk profiles following what has been a strong market run. As always, we would prefer to be seen as cautious rather than foolish.